

EUROPE'S NEW CAPITALISM

Bidding for the future

FRANKFURT, LONDON AND MILAN

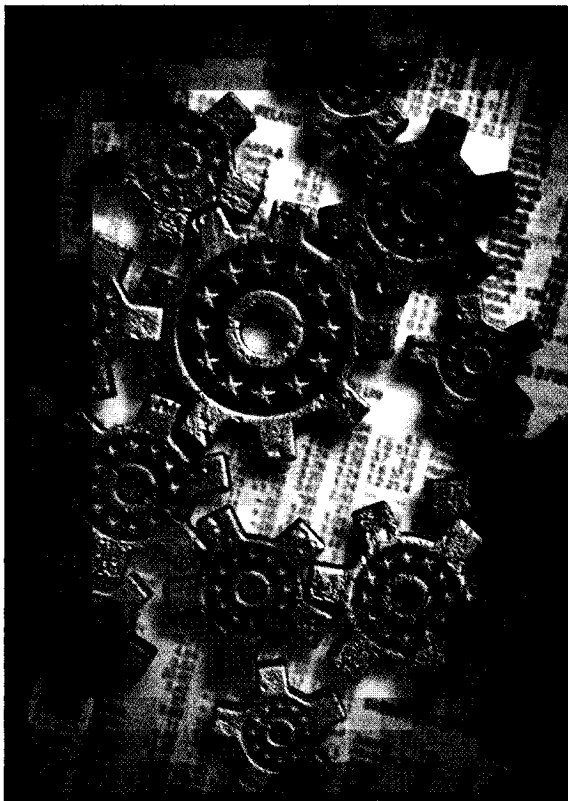
Vodafone's hostile, and successful, bid for Mannesmann is the biggest and most visible example of the growth in shareholder power that promises to remake European capitalism. On pages 19-22 we consider how flexibly the continent's parties of the left can respond to this—or any other—economic challenge. Here we examine its effect on Europe's companies and managers

N OBODY likes to throw in the towel, especially when the bell is only moments away. But, as Klaus Esser is aware, it pays to know when you are beaten. Mannesmann's boss fought hard to save his firm from the clutches of Vodafone AirTouch, but once he realised that he was on the ropes, he did the decent thing. Four days before the bruising takeover's deadline of February 7th, Mr Esser bowed to pressure from big shareholders—and, it is said, colleagues—and cut a deal with Chris Gent, his opposite number at Vodafone. In exchange for recommending the British group's hostile bid, worth some \$190 billion, Mr Esser won some valuable concessions for his shareholders. More surprising, he did so in the best American and British tradition: the deal cost him his job.

The world's biggest-ever bid was quite a spectacle, with three months of punch, counter-punch and even the occasional insult. But it was as remarkable for what did not happen as for what did. When Vodafone first launched its bid, few fancied its chances of surmounting all the obstacles that might be put in its way: resistance from Germany's politicians and unions, a legal fog surrounding takeovers, and all manner of dirty defences. Despite protesting at first, however, the politicians stayed out. Mr Esser resisted the urge to roll out the "barbed wire", insisting instead that investors should be the judges of the two companies' arguments. Indeed, both sides carefully listened to the markets during the battle. And at the moment of his defeat, Mr Esser delivered his remarkable verdict: "The shareholder is king."

As Germany's first properly contested takeover, this deal demonstrated a new transparency in the market for corporate control. In the past, hostile bids have mostly involved firms surreptitiously building stakes

in possible targets. Vodafone's open tender obliged the German authorities to clarify the rules of engagement. Now that the legal jungle has been hacked through for the first time, other would-be bidders may set out on the journey. Bankers think Germany will



soon see more bids for firms whose shares, like Mannesmann's, are widely held. Norbert Reis, the head of German investment banking at Credit Suisse First Boston, thinks the deal is "a wake-up call to anyone who thought they could rely on the old system" to see off unwelcome bidders. Anyone who thinks a merger makes commercial sense need no longer be deterred by legal, cultural or political uncertainty.

As Mr Gent begins to wrestle with the task of gaining regulatory approval for the bid and making the two huge telecoms groups into a single \$350-billion entity (see page 68), the rest of the world is wrestling with the question of what his coup means for Germany, and for Europe. One answer is already clear. The bid demonstrates that even the most successful firms can be taken over. Managers might not like that message, and may try to protect themselves by turning their backs on Europe's fast-developing capital markets. But that would consign their firms to the sidelines while Europe's industries restructure, and it could spell disaster in any competition with better-financed rivals.

As much as the Vodafone-Mannesmann deal is a cause of change, it is also a measure of how much Europe has changed already. Hostile takeovers were once taboo. But they

have recently succeeded in Italian telecoms and insurance, French banking and energy. Venture capital, leveraged buy-outs and cross-border mergers are booming. Old companies are shrinking and new ones springing up. Europe, which has for years been exporting more capital than it imports, may finally start to attract the investment from foreign financiers that it needs. And as a genuine market for corporate control is forged, managers might at last be held to account for their companies' performance.

Rhenish finished

Not everyone is delighted. German critics charge that the Mannesmann takeover is the first severe blow to their country's time-honoured system of Rhenish capitalism, which is built on consensus and close ties between bankers, industrialists, unions and the state.

In fact, that model has been crumbling for some time. Although corporate restructuring came more slowly to Germany than to America or Britain, German companies have for years been responding to the challenges and opportunities created by deregulation and the spread of competition across borders. A single page of a recent issue of the *Frankfurter Allgemeine Zeitung*, a leading German newspaper, featured articles about the Mannesmann battle, the planned flotation of the state railway, new rules on corporate governance, demergers and cut-throat competition among deal advisers. This sounds remarkably similar to the staple fare on the business pages of

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American newspapers.

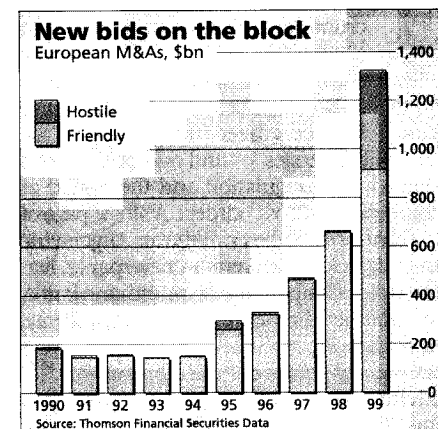
In the mid-1990s the idea of jettisoning peripheral activities to focus on a few core businesses was limited to a handful of pioneering conglomerates, such as Hoechst and Daimler-Benz. Hoechst's overhaul cleared the way for a merger with France's Rhône-Poulenc; Daimler's paved the way for its merger with America's Chrysler in 1998.

Since then, other firms have been refocused in similar ways, and some have completely reinvented themselves. When Vodafone pounced, Mannesmann was preparing to hive off into a separate company the engineering and automotive operations that formed its core until a decade ago (a move that pleased shareholders, but made the firm more vulnerable to takeover). Preussag has achieved a similar trick, moving deftly from old-line businesses such as shipbuilding and mining into package tourism.

Even lost causes are starting to come good. Siemens, a microchips-to-fridges conglomerate, has long been a sleeping giant, active in plenty of industries but a world-beater in only a few. Last year, after several failed attempts to restructure and boost profits, the company unveiled a radical plan to sell or float on the stockmarket businesses that employ a third of its workforce. As a result, its share price has more than tripled.

Behind this trend is a new generation of managers who understand that firms belong to shareholders, not bosses or "society". In the mid-1990s, "shareholder value" became a fashionable objective for big German firms. It was not, however, always pursued with much zeal. Veba, an electrical conglomerate, found favour with investors by promising to put their interests first, but failed to honour its pledges to restructure. Its shares shot up, then quickly fell again.

Such experiences have taught Germany's bosses, not least Veba's Ulrich Hartmann, that paying lip-service to shareholders is not enough. Most now know that a high share price makes acquisitions possible (just look at Vodafone) and that investors will mark down the shares of conglomerates unless, like America's General Electric, they are very well run.



Although many big German firms remain closely held, more of them want to widen their appeal to international shareholders and thus lower their cost of capital. Many are looking to list their shares on America's stockmarkets. Nine of Germany's biggest companies have already done so. Even in the *Mittelstand*, the medium-sized German firms that have been the powerhouse of the country's post-war success, many managers have begun to set themselves targets for return on equity.

Angered by cross-shareholdings

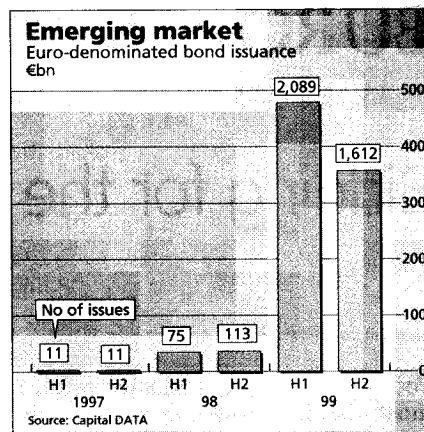
Underpinning these new attitudes is a fundamental shift in relations between Germany's companies and its banks. In Germany, as in much of Europe, commercial banks dominated the post-war financial landscape, lending large sums to corporate clients and often taking stakes in them, especially when they had trouble servicing their debts. This spun a web with such financial firms as Deutsche Bank and Allianz, an insurer, at the centre. Financial institutions were more interested in guarding their privileged position as a firm's banker or insurer than in acting as demanding shareholders.

No longer. Banks are pulling out of corporate lending, which offers paltry returns. They are also treating industrial stakes more like other investments. Deutsche Bank, which owns a €30 billion (\$29 billion) slice of corporate Germany, set up a special unit in 1998 to manage its stakes as a fund manager would. Axel Pfeil, who runs the unit, says he wants to "make bosses sweat". Allianz, Europe's largest insurer, has brought in Paul Achleitner, a former Goldman Sachs executive, to shake up its even larger holdings.

At the same time as the banks are becoming more active as shareholders, ordinary Germans are themselves piling into shares: in 1990-94, equity holdings averaged 10% of household disposable income. By the start of last year the figure had risen to 22%, according to Salomon Smith Barney (although Germany still lags far behind Britain, at 82%).

Thanks largely to the success of the Neuer Markt, the small-company stockmarket where both young technology firms and old family-owned businesses have flocked to list their shares, the number and value of initial public offerings are doubling annually. Venture capitalists have flocked in too, now that they can float their investments more easily. American-style share options have been legal in Germany only since 1998, but are fast becoming acceptable. Several big firms, including DaimlerChrysler, Siemens and SAP, a software firm, have set up schemes for top and middle managers. Many of the companies on the Neuer Markt have schemes for their entire workforce.

The arrival of shareholder capitalism has set the stage for more deals. But the action will be slow until a crucial piece of legislation has been repealed. Just before Christmas,



Germany's government proposed eliminating the capital-gains tax on sales of industrial stakes. If, as looks likely, the reform becomes law, banks, insurers and companies will be free to sell blocks of shares without paying a 50-60% tax on the difference between their low book value and high market value.

If so, the €250 billion-worth of large cross-shareholdings, which have in the past protected German firms from predators, could become their main vulnerability. Banks and firms seeking to become more efficient could redeploy capital from corporate investments to their core businesses by selling their minority stakes in other companies. Germany's nascent shareholder culture would benefit as blocks of shares were spread among many new owners. Passive shareholders would give way to active investors who seek out undervalued assets and expect a capital gain. German and foreign investors would jostle for stakes that could provide stepping stones to a bid.

The great virtue of this will be to keep managers on their toes. For every Mannesmann, whose shares are spread across many institutional investors, there are dozens of companies with at least one protective minority investor. It is no coincidence that such firms include MAN, Deutz, Linde, Metallgesellschaft, Continental, Holzmann, and other industrial companies whose shares have all lagged behind Germany's better performers. A company such as MAN, an engineering conglomerate, has everything to fear. With a third of its shares in the hands of Allianz, Munich Re and Commerzbank, two insurance firms and a bank, MAN has been able to delay restructuring. If its core shareholders were to sell their stakes, MAN would soon hear the knock on the door.

Europe, awake

Indeed, underperforming managers across Europe have reason to worry. The continent is caught in a merger boom, clocking up \$1.2 trillion of deals last year, a rise of almost 50% over 1998. Relative to the value of European stockmarkets, deals in Europe exceeded those in America for the first time in years.

Companies are increasingly looking out-

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side their home markets. Does Europe's single market and single-currency zone need twice as many car makers and ten times as many tractor makers as America? Executives think not. From 1990 to 1998, cross-border deals accounted for less than a third of European mergers by volume. Last year, they accounted for almost half the total.

This merger boom has two other eye-catching features. One is technology deals. Measured by value, last year's total was greater than the rest of the 1990s combined, according to Broadview International, an investment bank. The other feature is hostility. Last year, unsolicited bids counted for a third of the total by value, a huge rise. That level of activity is likely to persist, even without another bid on the scale of Vodafone's for Mannesmann.

Fear is as much of a motive as opportunity. Last week Compart, a holding company, bid €3.5 billion for the shares that it does not already own in Montedison, an Italian conglomerate. Compart's backers, which include Mediobanca, an Italian investment bank, feared that if they did not tidy up Montedison's financial structure themselves, someone else would do it for them.

In other industries, deregulation and globalisation are promoting deals that would otherwise have happened years ago. Consider energy. Having dabbled in chemicals, metals, logistics and telecoms, all three of Germany's main listed electrical utilities, Veba, Viag and rwe, are now concentrating on power generation in the hope that they can take advantage of deregulation to expand across Europe. Until recently, the oil and gas industry was dominated by national champions. This week it emerged that Eni of Italy and Repsol-YPF of Spain are talking about an alliance. Last month, Eni bought a strategic stake in GALP, a Portuguese energy group.

Across all industries, the euro is at work. The single currency has created a liquid market in European corporate bonds. Although this still pales beside America's corporate-bond market, it grew by 235% last year, even though global issuance fell. European firms are increasingly issuing euro-denominated bonds to refinance expensive bank debt, their traditional source of finance, and to raise money for takeovers. Olivetti's highly leveraged \$58-billion hostile takeover of Telecom Italia last year would have been impossible to finance only a couple of years ago.

Armed with a proper prospectus, even family firms can now raise large sums in international bond markets. This week, Marne et Champagne, a French champagne maker planning a stockmarket listing, said that it is

replacing bank debt with €400m in bonds, secured against its champagne stocks. Last year Camuzzi, an Italian gas-distribution firm, raised €200m via a syndicate of investment banks. Investors in the deal were a thoroughly international lot, reassured in part by the bonds' credit rating issued by Standard & Poor's.

As markets have flowered, so has corporate governance. Activist institutional shareholders are still rare in Germany, not least because the country lacks a properly funded pension system. However, some of the bigger fund managers, such as DWS and Union Investment, have growing influence over company bosses.

When managers know that they may have to call on the capital markets to finance

parted after his firm's takeover by TotalFina.

Aware that investors are now looking over their shoulders, managers are trying to communicate with them. ILTE, an Italian printing firm that is controlled by the family-owned Farina group, recently won a prize for its annual report. Firms that list on Germany's Neuer Markt must choose between accepted American or international accounting principles and must file quarterly accounts in German and English—an explicit acknowledgment that the market for their shares is international. Listed British firms have long been used to the "roadshow" needed to sustain a diversified shareholder base. More continental European firms are also now visiting large institutional investors to encourage them to buy (or hold) their shares.

One more push

Despite all this, Europe has a long way to go. By most measures, its firms remain laggards. Profit margins may be the highest since 1972, but they are still only half those of American companies. Owners cling to power at the expense of minority shareholders. One in five of Germany's 100 biggest companies—typically those with a history of family ownership—still issue preferred stock with special voting rights. Furthermore, European restructuring is at an early stage, with cost-cutting a priority. Having already cut costs, American firms such as America Online and Time Warner are by contrast merging to expand revenues or bring together convergent industries.

In some countries, structural rigidities are delaying progress. The failure to reform pensions affects national budgets, and also stunts the development of institutional shareholders. Radical restructuring and deregulation are threatened by union power and rigid labour markets. Vodafone's bid was for the high-tech part of Mannesmann, in which the

unions play only a small role. The bid might never have been made had the target included the engineering division.

Almost as worrying as labour protection is economic nationalism. In France, politicians are quick to decry foreign "invaders". Whereas French companies completed \$126-billion worth of deals outside France last year, foreigners completed deals worth only \$36 billion in France, mostly of smaller companies that would not arouse public ire.

Such barriers look set to fall. The revolution in European business has just begun. There may be hesitations and setbacks along the way, but the direction seems clear: a capitalism more transparent, more efficient and, yes, redder in tooth and claw.



bids—or fend them off—it can have a sobering effect on their behaviour. Rather than face a shareholder revolt, Olivetti abandoned a restructuring of Telecom Italia last year that would have cost minority shareholders a small fortune. Last month, a group of German business leaders, including Veba's Mr Hartmann, began to draft a set of corporate standards for listed companies. Their proposals include timely publication of share-sensitive information, sanctions against ineffective supervisory boards and an overhaul of top managers' pay.

In France last month, two business associations called for managers' pay packets to be made public. This followed a fuss last year over an undisclosed pay-out to Philippe Jaffré, the boss of Elf Aquitaine, who de-